US data surprises boost rate hike prospects

US inflation held up while retail sales were soft. The latter is temporary, higher inflation is not

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Today's US data has provided quite a few surprises. Inflation rates have held steady at 2.1% for annual headline consumer price inflation and 1.8% for the core rate (which excludes food and energy) rather than fall to 1.9% and 1.7%, respectively as the consensus had predicted. Meanwhile, retail sales were far softer than expected, falling 0.3%MoM versus forecasts of a 0.2% rise.

Starting with inflation, the main surprise came in apparel, which rose 1.7%MoM. We had suspected it would rebound at some point given its very soft run, but not quite as quickly (it is the biggest increase in more than 10 years). Energy also rose sharply – up 3%MoM, while medical care rose 0.4% (fastest growth for 6M).

As for retail sales, there was a wide range of forecasts (the Bloomberg survey had numbers ranging from -0.2% to +0.5%), which presumably reflected the uncertainty relating to bad weather at the beginning of the year. We had thought there would be a switch to internet sales, but it wasn't enough to offset the big fall in auto sales (-1.3%MoM). Building materials (-2.4%MoM), health (-1.2%) and sporting (-0.8%) were all weak, but clothing was up 1.2% and gasoline sales were up 1.6%.

We think the softness in retail sales is temporary. With tax cuts, record low unemployment, rising wages and high confidence levels suggesting the outlook for spending remains good. However, we think there could be more bad news for inflation. The dollar's declines will gradually push up import prices, while energy costs will add to the upside. Then there are last year's distortions relating to cell phone data plans dropping out of the annual comparisons from March. This on its own will add 0.2/0.3 percentage points to annual core inflation with medical care costs and housing costs pushing inflation higher too.

In an environment of strong consumer demand, corporates have the pricing power to pass on higher costs to customers, which is going to be increasingly significant given the prospect of a pick-up in wage growth. Taking this all together, we expect core inflation to be back above the Federal Reserve's 2% target in March with headline inflation hitting 3% by the summer. In turn, this healthy growth, rising inflation environment means that we consider there to be upside risk for our call of three Fed rate hikes in 2018.

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